

***United States Court of Appeals  
for the Second Circuit***



**APPELLANT'S  
BRIEF**



original \*

# 75-7203

To be argued by  
RONALD H. ALENSTEIN

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**United States Court of Appeals  
FOR THE SECOND CIRCUIT**

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ROBERT ABRAHAMSON and  
MARJORIE ABRAHAMSON,  
*Plaintiffs-Appellants,*

—v.—

MALCOLM K. FLESCHNER, WILLIAM J. BECKER,  
HAROLD B. EHRLICH, LEON POMERANCE,  
FLESCHNER BECKER ASSOCIATES, and  
HARRY GOODKIN & COMPANY,  
*Defendants-Appellees.*

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ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT  
COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

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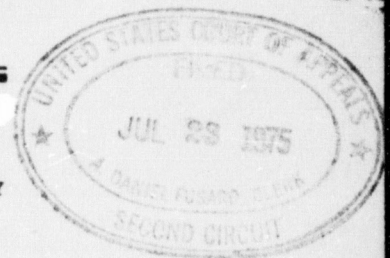
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**BRIEF FOR APPELLANTS**

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UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

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|----------------------------------|---|------------|
| ROBERT ABRAHAMSON and MARJORIE   | : |            |
| ABRAHAMSON,                      | : |            |
|                                  | : |            |
| Plaintiffs-Appellants,           | : |            |
|                                  | : |            |
| -against-                        | : | Docket No. |
|                                  | : | 75-7203    |
| MALCOLM K. FLESCHNER, WILLIAM J. | : |            |
| BECKER, HAROLD B. EHRLICH, LEON  | : |            |
| POMERANCE, FLESCHNER BECKER      | : |            |
| ASSOCIATES, and HARRY GOODKIN &  | : |            |
| COMPANY,                         | : |            |
|                                  | : |            |
| Defendants-Appellees.            | : |            |
|                                  | : |            |
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BRIEF FOR APPELLANTS  
PRELIMINARY STATEMENT

In this case plaintiffs-appellants have alleged violations of Rule 10b-5 under the Securities Exchange Act of 1934, and of Section 206 of the Investment Advisers Act of 1940. Plaintiffs and all defendants moved for summary judgment in the District Court. By order dated March 4, 1975, the Court granted defendants' motions for summary judgment dismissing the complaint, and denied plaintiffs' motion for summary judgment. Plaintiffs appeal from the order and from the judgment entered thereon.

ISSUES PRESENTED FOR REVIEW

1. (a) Where investors in securities (in the form of limited partnership interests in an investment partnership) are induced to enter into a new partnership agreement containing substantial modifications of material terms, have they made a new purchase of securities?
- (b) Where such investors have been induced to enter into such new agreement by misleading statements containing omissions of material fact, may they recover damages measured by the difference between the value they have given in exchange for their new partnership interests and the value they have received after their discovery of the fraud and consequent withdrawal from the partnership?
2. Where purchasers of limited partnership interests are induced not to sell their interests by misleading statements containing omissions of material fact, with the result that they hold their interests until the value thereof has decreased substantially, may not such purchasers recover damages based on

the amount they would have received had there been no such misleading statements and omissions, and had they been told the truth in time to withdraw at an earlier date when they would have received a higher price?

STATEMENT OF THE CASE

Nature of the Case, Course of the Proceedings  
and Disposition Below

Plaintiffs are former limited partners of defendant Fleschner Becker Associates ("FBA"), an investment partnership. Defendants Fleschner and Becker are general partners of FBA. Defendant Ehrlich was a general partner of FBA during part of the pertinent period. Defendant Harry Goodkin & Co. ("Goodkin") is a partnership of certified public accountants which audited the books of FBA for the fiscal years 1966, 1967 and 1968.

The complaint alleges violations of Rule 10b-5 under the Securities Exchange Act of 1934, and of Section 206 of the Investment Advisers Act of 1940. The principal claim in the complaint is that defendants concealed from plaintiffs the fact that an enormous proportion of the portfolio of FBA consisted of securities which were not registered with the Securities and Exchange Commission and which were subject to restrictions as to sale. Plaintiffs claim that this was a highly material fact, the concealment of which caused plaintiffs damages in excess of \$1,000,000, because when they withdrew from FBA, as soon as possible after they learned the truth, they received far less than they would have received had there been no fraudulent conduct.

Both sides moved for summary judgment. All defendants made the following assertions:

1. plaintiffs suffered no damages;
2. the FBA agreement of limited partnership signed by plaintiffs authorized the purchase of securities of every kind;
3. plaintiffs were entitled to inspect FBA's books and records and therefore were chargeable with constructive knowledge of the existence of FBA's extensive investment in unregistered securities; and
4. defendants were not "investment advisers" within the meaning of the Investment Advisers Act of 1940.

In addition, defendant Goodkin asserted that any material nondisclosures were not in connection with the purchase or sale of a security within the meaning of Rule 10b-5, and that it did not act in concert with any of the other defendants. Defendant Ehrlich asserted that no wrongdoing took place during the period in which he was a general partner of FBA.

Plaintiffs contended that each of these assertions is without merit. They believe that they should recover damages

under the rule for the measurement of damages most recently announced by the United States Supreme Court. They claimed that even assuming the FBA partnership agreement authorized the purchase of unregistered securities, it contained an implied representation that the general partners would not invest 98% of the portfolio in unregistered securities. In any event, plaintiffs urged, the charge here is not primarily that the purchases of unregistered securities were unauthorized, but that they should have been disclosed. Plaintiffs further contended that they were not "insiders," and are not chargeable with constructive knowledge of the content of FBA's books and records, regardless of any right of access they may have had. Finally, plaintiffs asserted that the defendants were "investment advisers" as a matter of law, that the fraudulent concealment was indeed in connection with the purchase or sale of a security, and that much of it took place while Ehrlich was a general partner and with his participation.

Plaintiffs contended that the fraud could be considered to be in connection with the sale of plaintiffs' interests, which was deferred during the period of the fraudulent misrepresentation and concealment and would have taken place at an earlier time but for such concealment; or, in the alternative, in connection with a purchase of securities, which should be deemed to have taken place when plaintiffs executed

a modified version of the partnership agreement, having been induced through fraudulent conduct to continue their investment in FBA on changed terms.

The District Court (Hon. Robert L. Carter) by a decision and order dated March 4, 1975 (290a) granted defendants' motions for summary judgment and denied plaintiffs' motion for the same relief. The court's decision was based solely on the conclusion that plaintiffs suffered no damages. The Court did not reach the remaining issues.

While there are a number of disputed questions of law, counsel for all parties are in agreement that the question whether plaintiffs sustained damages -- the only question decided by the District Court -- should, in order to minimize the burden on this Court and all parties, be the only question briefed and argued on this appeal. Should the Court reverse the District Court's holding on the question of damages, counsel believe that an appropriate disposition would be to remand the case for consideration of the other questions raised.

#### Facts

Plaintiffs are husband and wife who at all times have been residents of the State of Connecticut (138a). On or about July 1, 1965, they became limited partners of FBA (then known as

The Fleschner Co.) (140a). They did so as a result of several conversations with defendant Fleschner in late 1964 and in 1965 (142a). In these conversations, Fleschner invited them to invest in an investment partnership he was forming (143a). Plaintiffs, both of whom were getting on in years and planning retirement, expressed a concern for financial security and conservatism in investment, and both mentioned the depression which began in 1929 and which they both remembered (143a). Mr. Fleschner told them that his investment partnership would have a conservative investment policy. He said he intended to use some of the same techniques as another partnership named A. W. Jones. He showed plaintiffs a brochure describing A. W. Jones. He explained that one of the techniques would be short selling, which he said would enable him to protect the partnership assets in the face of a falling market (143a).

FBA started as a small partnership. By April 1, 1966, however, it had at least 35 limited partners. By October 1, 1968, it had at least 66 limited partners (141a).

Defendant Fleschner was at all times a general partner of FBA (141a). Defendant Becker was a general partner at all times from and after April 1, 1966 (141a). Defendant Ehrlich was a general partner from October 1, 1968 to September 30, 1969 (141a).

The original partnership agreement dated July 1, 1965 was replaced by subsequent agreements dated April 1, 1966, and October 1, 1968 (39a, 66a, and 87a). The 1968 amended agreement entirely restructured the relationships and rights of the partners, and contained a number of significant modifications which materially altered the nature of plaintiffs' investment. The modified agreement included such changes as a major expansion of the scope of investment discretion granted to the managing partners (89a), the addition of a substantial salary for the managing partners (90a), and a clause eliciting from the limited partners a statement of investment intent (105a). The plaintiffs executed this revised and restructured agreement, relying on the accuracy of representations previously made in financial and other reports, and unaware of material facts which had been and were to remain undisclosed (150a and 151a).

From the time of plaintiffs' initial investment until well into 1969, FBA prospered, according to the annual financial statements and monthly reports sent to partners. During this time the year-end financial statements were being certified by Goodkin and mailed to plaintiffs (143a). The financial statements contained balance sheets showing FBA's investment in securities (183a, 190a, and 204a). The securities were

not itemized in the balance sheets of September 30, 1967 and September 30, 1968 (183a and 190a).<sup>\*</sup> The figure set forth in these balance sheets for investment in securities was described as the "market value" (183a and 190a).

Goodkin sent drafts of the certified year-end statements to general partners of FBA for their review, prior to mailing the statements to limited partners (144a).

During this time, the general partners of FBA were also causing monthly reports to be sent to limited partners (146a). These reports were usually brief one-page statements, sent through the mails from FBA's Manhattan office (146a). The reports usually set forth the percentage increase or decrease in the value of FBA's investments for the year to date, and compared this performance with the performance during the same period of the Standard & Poor's 500 Stock Average (146a). The reports also often contained comments characterizing the performance or position of FBA. The following are examples of some of these comments:

1. "We continue to maintain a low risk stance" (report dated November 2, 1967) (198a);

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<sup>\*</sup> FBA was reporting on the basis of a fiscal year ending September 30.

2. "We remain in a most conservative posture"  
(report dated December 1, 1967) (199a);
3. "We have maintained the previously mentioned  
low risk stance through the current market weakness"  
(report dated February 2, 1968) (200a);
4. "Our investment posture remains most conserv-  
ative" (report dated April 2, 1968) (201a);
5. "It was another good year" (1968 year-end re-  
port, which also stated that FBA had increased its  
capital by approximately 90%) (202a).

Although plaintiffs did not know it at the time, FBA was in the process of increasing its investment in unregistered securities from approximately 15% of the portfolio to approximately 72% of the portfolio between September 30, 1967 and September 30, 1968 (148a).<sup>\*</sup> It was doing so while simultaneously sending reports to limited partners such as the one which stated that its "investment posture" was "most conservative."

Between September 30, 1968 and September 30, 1969, the investment in unregistered securities ranged from about 72% of the portfolio to about 98% of the portfolio (150a).<sup>\*</sup> The monthly

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<sup>\*</sup> Defendants' papers in the Court below contained somewhat different -- although still very substantial -- percentage figures. This was because defendants compared FBA's unregistered securities to total assets instead of to total investments in securities.

reports in this period continued to summarize FBA's performance in comparison with the Standard & Poor's 500 Stock Average, but made no mention of the unregistered securities (149a).

During the period in which plaintiffs were FBA limited partners, FBA made between 40 and 80 separate purchases of unregistered securities, involving the securities of approximately 40 different issuers (151a).

In late December, 1969 or early January, 1970, plaintiffs received the certified financial statements for the year which had ended on September 30, 1969 (150a). These statements had been prepared, not by Goodkin, but by a new auditing firm named Brach Lane Hariton & Hirschberg (150a). Footnote 1 to the financial statements revealed, for the first time, that of FBA's total investment in securities (\$39,355,310), approximately 77% (\$30,411,868) consisted of unregistered securities (150a).

The partnership agreement in effect at this time provided that limited partners could withdraw only at the end of a fiscal year and only upon 60 days' notice (100a).\*

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\* It is noteworthy that the partnership agreement dated October 1, 1968, also provided that all distributions to withdrawing partners would be in cash or "marketable securities."

By the time plaintiffs received the financial statements for fiscal 1969, it was too late for them to withdraw as of the end of that fiscal year. They withdrew at the earliest possible time after receiving the 1969 statements revealing the investment in unregistered securities, i.e., September 30, 1970 (152a).

Had plaintiffs been informed of the facts in time to withdraw as of the end of fiscal 1968, i.e., as of September 30, 1968, plaintiff Robert Abrahamson would have received \$605,076.47 (the value of his capital account) and plaintiff Marjorie Abrahamson would have received \$1,141,386.14 (the value of her capital account), less certain charges provided for in the partnership agreement (152a). If plaintiffs are viewed as having made a new investment as of October 1, 1968, the date of the modified partnership agreement, then they paid \$605,076.47 (in the case of Robert Abrahamson) and \$1,141,386.14 (in the case of Marjorie Abrahamson), these amounts being the values of their capital accounts transferred to the newly-constituted partnership in return for new limited partnership interests.

The amount received by Robert Abrahamson on his withdrawal as of September 30, 1970 was \$150,097, and the amount received by Marjorie Abrahamson was \$341,565 (152a).

### POINT I

PLAINTIFFS MAY BE VIEWED AS INVESTORS WHO WERE INDUCED BY MATERIAL OMISSIONS AND MISLEADING STATEMENTS TO MAKE A NEW INVESTMENT IN OR ABOUT 1968, WHEN THEY EXECUTED A SUBSTANTIALLY MODIFIED LIMITED PARTNERSHIP AGREEMENT; ON THIS BASIS, PLAINTIFFS SHOULD BE AWARDED DAMAGES MEASURED BY THE DIFFERENCE BETWEEN THE VALUE THEY GAVE IN RETURN FOR THEIR NEW INTERESTS AND THE VALUE THEY RECEIVED ON DISPOSITION OF THOSE INTERESTS.

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Plaintiffs' initial investment in defendant Fleschner's investment partnership was in 1965. But late in 1968, or early 1969 plaintiffs were asked to execute a new partnership agreement whose effective date was October 1, 1968. This agreement, nominally an amendment to the 1966 agreement, in fact was a comprehensive revamping of the investment contract among the partners. Structure and terminology were totally revised and numerous modifications, many of significance, were incorporated. The following table highlights some of the most pertinent changes:

| <u>Term</u>                               | <u>1966 Agreement</u>  | <u>1968 Agreement</u>   |
|---|--|---|
| 1. Scope of Authority of Managing Partner | Limited basically to securities and commodities transactions. (Art. 3) | "Purpose of Partnership" greatly expanded to include, <u>inter alia</u> , power to engage in other businesses; to lend property or funds with uncontrolled discretion as to amount, interest, and requirement of security, to open new offices, and to engage independent personnel. (1.04) |

| <u>Term</u>   | <u>1966 Agreement</u>   | <u>1968 Agreement</u>  |
|---|---|--|
| 2. Salary for Managing Partner                        | No salary provision for "Executive Committee" members.  | General partners may designate managing partners to receive \$25,000 per year as salary. May designate unlimited number. (2.01)  |
| 3. Partnership Charge on New Contributions to Capital | Up to 2% on cash, discretion of executive committee on securities contributed. Must be uniformly assessed upon all contributions related in time. (Art. 2)                      | Up to 1% on cash, 2% on securities contributed. No uniformity requirement. (3.01)  |
| 4. Resolution of Disputes                             | All disputes of "any nature whatsoever" conclusively determined by Executive Committee. Also covenant among partners not to maintain suit against partnership except for fraud. | Managing partners empowered to conclusively determine only matters relating to valuation and allocation of profits, gains and losses where not expressly covered by agreement. No covenant not to sue. |
| 5. Loans to Limited Partners                          | Limited Partner could borrow up to 10% of capital account, interest 1% over prime rate.   | Amount increased to 25%. Interest rate in discretion of managing partners. (4.01)  |
| 6. Managing Partner Mid-year withdrawals of capital   | No provision for withdrawals other than at end of fiscal year. (Art. 8)   | May be done at any time or times during year, in increments of 10% of total capital accounts of all partners. (4.02)   |
| 7. Regular withdrawals by Limited Partners            | Quarterly "draw" of 4% of capital account. (Art. 8)   | No comparable provision.   |

| <u>Term</u>   | <u>1966 Agreement</u>  | <u>1968 Agreement</u>   |
|---|--|---|
| 8. Withdrawals of Capital by Limited Partners                       | Year end, 60 days notice.  | Year end, 30 days notice.   |
| 9. Liquidation Delays in Connection with Withdrawing Partner Payout | Executive Committee vested with discretion to postpone valuation and payout to withdrawing partners upon judgment that assets cannot be disposed of at proper value at that time. (Art. 5) | No comparable provision.  |
| 10. Residual Benefits of Withdrawing Managing Partners              | No provision for benefits for Executive Committee member after withdrawals.  | Withdrawing Managing Partner participates in capital gains for 3-year period after withdrawal. (6.04)                   |
| 11. Duration of Partnership   | Perpetual unless terminated by affirmative action. (Art. 1)  | Terminates automatically 10 years from agreement (7.01)   |
| 12. Effect of withdrawal of General Partner                         | No automatic dissolution. (Art. 7)   | Automatic dissolution. (6.02)   |
| 13. Method of Distribution on withdrawal                            | Distribution in cash, in kind, or in both. (Art. 6)  | Distribution in cash or marketable securities (7.03).   |
| 14. Amendments  | Province of Executive Committee - amendments may affect "administrative matters" only. (Art. 12)   | General amendatory power - joint approval of 1/2 limited partnership interests, 2/3 of general partner interest. (9.03) |

|     | <u>Term</u>               | <u>1966 Agreement</u> | <u>1968 Agreement</u>  |
|-----|---------------------------|-----------------------|--|
| 15. | Investment Representation | No provision.         | All signatories represent interest is acquired for investment purposes. (9.04) |
| 16. | Reports to Partner        | No provision          | Requires regular circulation of detailed reports. (8.02)                       |

Some of the above changes no doubt attracted the investors to remain in the fold; others must have created opposite inclinations; with respect to still other provisions, advantages and disadvantages were difficult to predict. But it is certain that the limited partners were compelled to make a new investment decision. The changes presented to them were of substance.

It is settled that when the contractual provisions of an investment relationship undergo material modification in any respect, a new purchase of the security is deemed to have occurred. Form and nomenclature do not take precedence over substance when an investor's rights pertaining to a security are altered. Whether the issuer proceeds by stamping a modification on the face of the security, by amending a corporate charter or by-laws, or by physically exchanging an old document for a new one, a new security is issued or sold if the investor's rights are altered. As is stated in Jennings and Marsh, Securities Regulation (3d Ed., 1970) pp. 474-75:

"Although the definition of "sale" does not in terms include an exchange, the courts have had no difficulty in finding an exchange of securities to be a sale. . . . The matter seems quite clear when the security holder voluntarily surrenders the document evidencing the security and receives an entirely new security. But an exchange proposal may result in a substantial change in the rights of an outstanding security without a physical change of securities. . . . Moreover, a change in the rights of outstanding securities by way of a charter amendment or otherwise, even though authorized by the law of the state of incorporation, entails the issue and sale of a new security." (Emphasis added.)

In the leading case of SEC v. Associated Gas & E. Co., 24 F. Supp. 899 (S.D.N.Y. 1938), aff'd 99 F.2d 795 (2nd Cir. 1938) the mere stamping of a modified term upon an investment certificate issued by a public utility holding company was held to be the sale of a new security within the meaning of the Securities Act of 1933 and the Public Utility Holding Company Act of 1934. In Associated Gas the defendant issuer had stamped a legend on outstanding investment certificates whose maturity date was approaching, reciting that a portion of the certificate was to be redeemed and the unpaid portion would become due at a later date than that originally specified, while continuing to bear interest at the same rate.

The defendant in Associated Gas, resisting the SEC's action to compel it to register the stamped certificate as a new security sold as of the date of modification, argued that

no "sale" of the security had occurred. The District Court rejected this view, holding (24 F. Supp. at 903):

" . . . [T]he Court has no difficulty in determining that the stamped certificates mailed by the Company's agent, the defendant Transfer and Paying Agency, described as a Jersey business trust, constituted the sale of a security. The purpose and aim of the Company is to secure the retention and use of the certificate holders' money for a further period after the present due date, November 15, 1938. Whether on that day the holder takes \$80 from his pocket and pays it over to the Company or whether he allows the Company to retain the \$80 it has of his money cannot alter the case."

At another point in the opinion the Court made it even clearer that the absence of a physical transfer of money does not prevent a modification of an agreement from being a sale within the meaning of the Securities and Public Utility Holding Company Acts (page 905):

"We think the stamped certificates are sold within the meaning of the statutes. Indeed, we believe this follows from our conclusion that the stamped certificate is a security. It was disposed of when it was stamped or certainly when it was mailed to the holder by the defendant Transfer and Paying Agency for the use of the certificate holders' money for the period of the extension. When the original certificate was delivered to the subscriber in exchange for his cash, there certainly was a sale. Here a new promise to pay a different amount, at another date, is delivered for the cash that belongs to the holder and which he substantially redelivers or, if the defendant prefers, for the holder's waiver of immediate payment." (Emphasis added.)

On appeal, this Court affirmed, saying  
(99 F.2d at 797):

"Why a stamp on the old certificates extending their maturity when accepted by the owner would not amount to the issue or sale of a security is hard to see. . . . There would be a legal consideration for the new obligation and the fact that the same piece of paper would contain the earlier and the later obligation seems quite immaterial. To treat the proposed arrangement as beyond the jurisdiction of the Securities and Exchange Commission would seem to place form above substance and to defeat the statutory purpose of safeguarding the public interest by affording the means of investigating the merits of such transactions by the Commission so that issues of securities may be stopped if found inexpedient for the security-holders."

We think that the application of the principles of Associated Gas to the case at bar is clear and direct. In both cases the investors agreed to continue their investment with the issuer -- without any formalistic surrender and reconveyance of the sums invested -- in conjunction with a modification of the investors' rights reflected on documents received by the investors. In Associated Gas the old security was merely stamped with the legend reciting the new term; in the instant case, of course, the old security was replaced by a completely new one. The Associated Gas court found a sale of the security; the same result should obtain a fortiori in the instant case.

Two other cases involving criminal prosecutions for fraud in the sale of securities illustrate that a sale will be found where one document evidencing the security is exchanged for a new document although the underlying amount invested remains essentially the same. These cases are United States v. Werner, 157 F.2d 797 (7th Cir. 1946), where the court held that the exchange of beneficial trust certificates for limited partnership certificates, both securities representing shares in the same underlying oil leases, constituted the sale of securities although no new funds passed from the investors to the defendants; and United States v. Riedel, 126 F.2d 81 (7th Cir. 1942), where, quite similarly, on evidence that "voucher certificates" issued by a trust estate were exchanged for stock certificates issued by the same controlling defendant, the court found the sale of a security to have occurred and upheld the fraud conviction.

A more recent case illustrating that modification of rights of security holders will be deemed the issuance or sale of a security is United States v. New York, New Haven & Hartford R. Co., 276 F.2d 525 (2nd Cir. 1960), cert. den. 362 U.S. 961 (1960). There the Court was asked to decide whether the defendant carrier had violated §20(a)(2) of the Interstate Commerce Act by failing to obtain approval of the ICC before

issuing "any share of capital stock or any bond or other evidence of indebtedness." As Judge Friendly phrased it (p. 527):

"The question here is whether a railroad subject to §20a of the Interstate Commerce Act, 49 U.S.C.A. §20a, can lawfully provide by agreement for significant changes in the rights and privileges of holders of 27% of its preferred stock without having obtained authorization from the Interstate Commerce Commission."

The modifications involved, inter alia, the waiver of dividend rights for one year and the postponement of certain "put" rights of the investors.

The Court found that a new issue had resulted although the changes had been accomplished only by charter amendment rather than by substitution of a new document for an old one (as in Werner and Reidel, supra) or by altering the face of the pre-existing document (as in Associated Gas, supra). The Court stated (p. 531):

"The difference between a change in the terms of an outstanding security and its retirement and reissue is largely formal; and Congress could not have intended the Commission to be placed in a position where securities that the Commission had authorized on the basis of particular terms and conditions could be changed into quite different ones without its approval."

The Court made it clear that it considered the question before it essentially the same whether the legis-

lative context might be the Interstate Commerce Act or the securities laws. It pointed out that it had previously relied upon ICC precedents in deciding that a sale had occurred in SEC v. Associated Gas, supra, and cited Associated Gas as controlling authority in the case before it (p. 531):

"Appellees do not succeed in distinguishing Associated Gas on the basis of the broader definition of 'security' in §2(a)(16) of the Holding Company Act, 15 U.S.C.A. §79b(a)(16); for there the question was not whether the certificates were a 'security' but whether their extension was an 'issue on sale'."

Associated Gas and Werner are cited and followed in the recent case of Ingenito v. Bermec Corporation, 376 F. Supp. 1154 (S.D.N.Y. 1974). In Ingenito the Court considered at length the very question presented in the case at bar, the question whether various modifications of a previously issued investment contract were in substance a new sale or issuance which, because of alleged fraud, could form the predicate for Rule 10b-5 liability.

The investor-plaintiffs in Ingenito were purchasers of interests in a cattle-raising venture. They had executed promissory notes (referred to by the Court as "herdowner notes") under which periodic installments were payable to the issuer, and received from the issuer in return certificates of title covering the animals and maintenance contracts for the care

of the animals. 376 F. Supp. at 1162. Thereafter, when the investors had expressed dissatisfaction with the progress of the venture, certain modifications were agreed upon, pursuant to which new promissory notes were substituted for the old ones and the terms of the maintenance contract were adjusted. The new promissory notes extended the time for payments by the investors and also contained waiver of defense and estoppel provisions, while the maintenance contracts were changed to provide for lower monthly payments.

The Court held, inter alia, that both the exchange of herdowner notes and the exchange of maintenance contracts were, in and of themselves, purchases of securities within the meaning of the securities laws and, more particularly, Rule 10b-5. The Court began with the principle that Rule 10b-5 is to be construed "flexibly, not technically and restrictively," citing Superintendent of Insurance of State of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971) and proceeded to analyze the case as one belonging in the Associated Gas line of decisions. The Court's reasoning appears in the passage at pages 1179-80:

"Although there appears to be no authority precisely in point, we are guided both by the rule that the securities laws should be construed with an eye to their remedial purpose and by decisions in analogous cases. We begin with the general proposition that an exchange of securities is a securities trans-

action for purposes of §10(b) even when there is no purchase in the usual commercial sense."

\* \* \* \* \*

"Certain general principles emerge from the somewhat disparate factual patterns in these cases. §10(b) by its terms embodies the judgment that 'purchases' and 'sales' of securities present the greatest possibility of fraud. Accordingly, such cases as Associated Gas and Werner seem to stand for the proposition that a purchase or sale arises when the nature and terms of an investor's involvement in a business enterprise are substantially altered by the creating of new rights or obligations. Construing the pleadings liberally as we are required to do and giving due weight to the investment context of the alleged fraud we find, for the reasons elaborated below, that the exchange of maintenance contracts meets this test and is a sufficient jurisdictional basis for the assertion of a §10(b) claim." (Emphasis added.)

The Court rejected the contention of one of the defendants that the modifications of the underlying investment agreement could not be viewed as a new sale because no new investment decision was involved. It stated (pp. 1181-82):

"Finally, we disagree with the State Mutual's contention that the exchange of maintenance contracts did not represent a new 'investment decision' and consequently is not a sale. The maintenance contracts, as noted above, were pivotal to the herdowner's investment 'package' and required on-going payments over a period of time. The herdowner exchanging his contracts was indeed making an investment choice: whether to sell his herd immediately, or to commit himself to further substantial payments to increase his equity by breeding more cattle and 'growing' healthy ones to maturity. Without attempting to define the precise contours of a §10(b) event, we find that threshold §10(b) jurisdiction is established

where, as here, there is alleged a substantial modification of an investment contract creating fresh rights and obligations of the parties and the investor gives some consideration, either a promise of future payments or the relinquishment of a significant right." (Emphasis added.)

The principles emerging from Associated Gas, Ingenito, and kindred cases clearly point the way in the present case. Here, an entirely new document, the 1968 partnership agreement, was exchanged for the 1966 agreement and many material modifications in the investor-issuer relationship took effect. And while the issuer labelled the transaction an "amendment" of the 1966 agreement, the cases discussed establish, above all, that forms or labels cannot alter what is in substance an exchange, and hence a sale, of a security. The cases further show that retention of the invested sums by the issuer during the modification transaction does not alter the effect; in the language of Associated Gas, supra, 24 F. Supp. at 905, the investor "substantially redelivers" the invested sums in the course of such purchase. As in the Ingenito case, where a material modification of terms is proposed, a new "investment decision" is presented and all of the protections afforded securities purchasers by the law operate to guard the integrity of the transaction. If fraud should taint the process, Rule 10b-5 liability may be imposed. Ingenito v. Bermec, supra,

376 F. Supp. 1154, 1182.

Sixteen examples of modifications are listed at page 14, above. We respectfully urge that each of these modifications was of significance. For example, §1.04 of the 1968 agreement greatly expanded "purposes of the partnership," and thus the scope of business ventures which could be entered into. Under the prior agreement, an investor's money could be invested only in securities and commodities (Art. 3); in the new agreement, the managing partners were authorized to put the investor's money in "such other businesses, activities and transactions as the Managing Partner may from time to time determine," §1.04(b) or to "lend funds or properties of the Partnership either with or without security," §1.04(a).

Three new provisions conferred upon the managing partners substantial benefits and privileges they did not enjoy under the 1966 agreement. For example, the investors were asked to agree to a salary of \$25,000 per annum to as many managing partners as the general partners should elect, §2.01; there had been no provision for salaries previously.

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\* References are to article numbers of 1966 agreement (66a) and sections of the 1968 agreement (87a). See reproductions in appendix for full text.

The new agreement also granted to managing partners only the right to withdraw portions of invested capital from time to time during the year, §4.02. (The limited partners were forbidden from making withdrawals of capital apart from borrowing against capital, until the end of the fiscal year, §§4.02, 4.03.) The new agreement also granted for the first time the right to managing partners to participate in capital gains generated by the partnership for a three-year period subsequent to the withdrawal from the partnership, §6.04. These changes constituted substantial and valuable rights running to the managing partners. They thus constituted substantial economic detriment to the limited partners.

The decision of the investor might also have been affected by the promise in §7.03 of the new agreement to make distributions in cash or "marketable securities." The comparable provision in the 1966 agreement merely entitled the partner to distributions in cash or "in kind" (Art. 6).

We submit that these examples, as well as others enumerated in the list of material modifications on page 14, supra, satisfy the Ingenito text, 376 F. Supp. at 1182, to the effect that

"a purchase or sale arises when the nature and terms of an investor's involvement in a business enterprise are substantially altered by the creation of new rights or obligations."

That the limited partners made a new investment decision at the time of the 1968 agreement is underscored by §9.04, which reads as follows:

"Investment Representation. Each Partner, by executing this Agreement, represents and warrants that his interest in the Partnership has been acquired by him for his own account (or for accounts as to which he has sole investment discretion) for investment and without any intention of further distributing such interest, that he does not presently have any reason to anticipate any change in his circumstances, or any other particular occasion or event which would qualify this representation and warranty, and that he is fully aware that in agreeing to admit him as a Partner the Partnership is relying upon the truth and accuracy of this representation and warranty."

If the execution of the 1968 agreement had not been the purchase of a new security, there would have been no reason to include an "investment representation."

We think it is clear that the 1968 agreement presented plaintiffs in this case with a new "investment decision," and that they purchased a new security when they signed it.

\* \* \* \* \*

We argued this point to the District Court.

At page 44 of our Memorandum of Law below we said:

"It is also possible to view plaintiffs' execution of the revised FBA agreement of limited partnership, dated as of October 1, 1968, as the 'purchase' of a security. The limited partners were sent the new agreement and requested to sign it at about the same time as the 1968 certified financial statements were being circulated. They signed the new agreement in reliance upon the information they had been receiving in the certified annual statements and in the monthly reports. They also signed on the basis of the statement in ¶7.03 of the agreement that distributions to withdrawing partners would be in cash or 'marketable securities' or both. This statement, we urge, constituted an implied representation by the general partners that they would not permit FBA to become as illiquid as it did. Plaintiffs might thus be viewed as having transferred to the partnership as newly constituted, under the October 1, 1968 agreement, a sum equal to the value of their investment in the old partnership, in return for limited partnership interests in the newly constituted partnership. On this view, plaintiffs' damages would still be \$454,979 in the case of Robert Abrahamson, and \$799,821 in the case of Marjorie Abrahamson. These figures would represent the difference between what plaintiffs paid and what they received upon withdrawal. See Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970)."

The District Judge acknowledged the argument, but we respectfully suggest that he failed to perceive its importance to the question of damages. The District Judge said (301a-302a):

"Plaintiffs have consistently maintained that the termination of their partnership interests was a 'sale' of securities. However, they also argue that the execution of their 1968 partnership agreement can be viewed as a purchase of securities. Plaintiff's Memorandum at 44. Consequently, there is no need to consider any possible difference regarding the measure of damages in a buyer's Rule 10b-5 suit versus a seller's suit, though there is little likelihood that any difference remains in this Circuit. See Zeller v. Rogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973)."

The Court below evidently did not see that if plaintiffs purchased a new security when they signed the 1968 agreement, then their damages are substantial, even under what the Court referred to as the "traditional" or "out of pocket" test (305a). The Court did not understand that if the signing of the 1968 agreement was the purchase by plaintiffs of a new security, then the price paid was the value of the interests transferred to the newly-constituted partnership, which in this case aggregated \$1,746,462.

On this view, as we urged below, plaintiff Robert Abrahamson's damages would be \$454,979, and plaintiff Marjorie Abrahamson's damages would be \$799,821. These figures represent the difference between what plaintiffs paid for their new interests when they executed the 1968 agreement, and what they received upon withdrawal. See Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2nd Cir. 1970), wherein this Court said (p. 1173):

"The amount of damages granted in this case, \$18,616.64, was the difference between the purchase price to Chasins (\$34,950.00) and the amount Chasins received when he subsequently sold the securities (\$16,333.36) prior to his awareness of a violation of the Securities Exchange Act and the rules promulgated thereunder. Such a measurement is justified where, as here, the evil is not the price at which Chasins bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of Smith, Barney's interest; the damages granted were proper under the circumstances." (Emphasis added.)

## POINT II

PLAINTIFFS MAY BE VIEWED AS INVESTORS WHO WERE INDUCED BY MATERIAL OMISSIONS AND MIS-LEADING STATEMENTS TO HOLD THEIR SECURITIES UNTIL THE VALUE THEREOF HAD SUBSTANTIALLY DECREASED, WITH THE RESULT THAT THEY SOLD FOR AN AMOUNT FAR LESS THAN THAT OBTAINABLE EARLIER; ON THIS BASIS, PLAINTIFFS SHOULD BE AWARDED DAMAGES MEASURED BY THE DIFFERENCE BETWEEN WHAT THEY RECEIVED FOR THEIR SECURITIES AND WHAT THEY WOULD HAVE RECEIVED HAD THERE BEEN NO FRAUDULENT CONDUCT.

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Defendants maintain that the amounts withdrawn by plaintiffs from FBA during the period of their investment plus the amounts distributed to them upon their withdrawal as limited partners exceeded the amounts they contributed to FBA. Plaintiffs concede that their contributions did not exceed the totals they withdrew and received upon distribution.

Defendants have urged, on the basis of these facts, that plaintiffs suffered no damages. Defendants point to Section 28 of the 1934 Act, which provides that plaintiffs in civil actions under the Act may recover only their "actual damage."

We believe defendants' contention is incorrect as a matter of fact, because they have treated the occasional withdrawals by plaintiffs during the five year period of

their investment as if these withdrawals constituted returns of capital. In fact, in many instances, the withdrawals by plaintiffs were withdrawals of portions of their shares of the partnership income. It is submitted that these withdrawals should not be counted in determining the price received by plaintiffs upon their sale of their partnership interests. Even if defendants were entirely correct that a defrauded seller has no claim if he has received upon his sale no less than what he paid, which we dispute, we think such a seller is entitled to a return on the sums he has invested during the period they remain invested. To count such a return as part of the sale price received for purposes of determining damages is in effect to deprive the investor of this right. See, e.g., Fox v. Glickman Corp., 253 F. Supp. 1005 (S.D.N.Y. 1966), wherein a compromise of several class actions under the securities laws was approved. The Court specifically approved a provision reducing damages by the amount of dividends received, because these dividends constituted a distribution of capital and not income. The Court said (p. 1010):

"The dividends paid by the Corporation up to January 1963 are to be subtracted from any damages claimed by a shareholder. These distributions were a return of capital and not taxable to the stockholders. Therefore, the deduction is proper."

In any event and even if all withdrawals are counted

in determining the price received by plaintiffs, we respectfully urge that in the circumstances of this case damages should be held to be the difference between what plaintiffs received upon the sale and what they would have received had they been told the facts at the appropriate times.

In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the plaintiffs alleged a violation of Rule 10b-5, and sought damages on account of a concealment from them of material facts in connection with their sale of securities. On the question of damages, the Supreme Court said (p. 155),

"In our view, the correct measure of damages under §28 of the Act . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct . . ."  
(Emphasis added.)

This rule, we urge, is applicable here. Like the Ute Citizens case, this case involves a claim under Rule 10b-5 for damages by reason of a concealment of material facts from a seller of securities. It is plain that if there had been no fraudulent conduct here, plaintiffs would have seen that the investment of FBA in unregistered securities was reaching monstrous proportions in time to withdraw as of the end of fiscal 1968, and would have received far more than they ultimately did receive.

If defendants' interpretation of the law were correct, a corporation such as Texas Gulf Sulphur would be free to issue misleading press releases causing investors to sell its securities at a time when announcement of a valuable mineral find is imminent. In such circumstances, under defendants' theory, if the sellers received in such fraudulently induced sales at least what they had paid for the stock, they would have no claim.

We think that the law is otherwise, and that a seller of securities who has lost the opportunity to earn an ascertainable profit because of conduct in violation of Rule 10b-5 may recover that profit.

In Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), cert. den., 404 U.S. 1004 (1971), 405 U.S. 918 (1972), the facts of which are well known, the plaintiffs had sold their TGS stock immediately after the April 12, 1964 press release minimizing the importance of the ore discovery. Without any discussion of whether the plaintiffs had made a profit or suffered a loss on their sale, the Court held that they were entitled to recover on the basis that they were "wrongfully deprived of their gain" (p. 106), that is, the gain they would have earned had they held their stock until a reasonable time after

April 20, 1964, the date by which the actual facts had become current knowledge throughout the marketplace. The Court said that the "damages then should be based on the highest value of TGS stock between Monday, April 20 and a reasonable time thereafter" (p. 105).

A somewhat similar result was reached in Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965), cert. den., 382 U.S. 879 (1965). There, the plaintiffs had sold securities because of false representation. They were awarded damages on the basis of profits they might have made had they not sold, which profits were made by the buyer.\* Janigan was cited with approval by the Supreme Court in Affiliated Ute Citizens v. United States, supra, 406 U.S. 128, 155 (1972).

Defendants have urged that in a Rule 10b-5 action, damages based on gains which might have been earned are not recoverable. This is often the case where such gains are speculative.

There is nothing speculative or uncertain about the gain plaintiffs here would have earned absent defen-

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\* We do not claim that Janigan is squarely on point, because here the defendants did not obtain the plaintiffs' lost profit. Nevertheless, Janigan shows that lost profits may be "actual damages" for purposes of section 28.

dants' conduct, and of which plaintiffs were "wrongfully deprived." Mitchell v. Texas Gulf Sulphur Co., supra, at 106. The value of their partnership interest on September 30, 1968 has been fixed by the defendants themselves, by means of the certified financial statements. In fact, defendants Fleschner and Becker received compensation based upon the values shown in the certified financial statements. The partnership agreements provided that the general partners would receive 20% of the net operating profits of the partnership and 20% of its realized capital gains in each fiscal year. See, e.g., Exhibits B (66a) and C (87a) to affidavit of William J. Becker. The general partners took advantage of these provisions, as is evidenced by the financial statements attached as Exhibits 3 (183a), 4 (190a) and 11 (204a) to plaintiffs' affidavit.

Nor is the amount actually received by plaintiffs upon their withdrawal as limited partners in doubt. That amount was asserted in the moving papers of defendants themselves.

The general partners transferred from the accounts of the limited partners to their own accounts 20% of the partnership profits, calculated on the basis of the certified financial statements. They cannot claim that the value

plaintiffs would have obtained had they withdrawn and been paid the amounts indicated in those statements is speculative.

Lost profits have been awarded as damages in other Rule 10b-5 cases. See, for example, Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3rd Cir. 1974). In Rochez Bros., the plaintiff purchased 50% of the stock of a corporation on July 1, 1964 for the sum of \$272,500 (p. 405). The defendant owned the other 50%. On November 13, 1967, the defendant purchased the plaintiff's 50% (p. 405), for the sum of \$598,000 (p. 406). Sometime later, in July of 1968, the defendant entered into an agreement with another corporation to sell the stock for substantially more than he had paid for it. The Court awarded damages based upon the price received for the stock by the defendant. To be sure, the Court regarded the case as one falling within the rule of Janigan v. Taylor, supra, and recognized that the damage award was in some respects a means of depriving the defendant of a windfall unlawfully earned. The Court went further, however. It squarely held that the defendant's conduct did cause the plaintiff "financial injury" (p. 416). The Court, recognizing that the plaintiff had made a profit, nevertheless held that the plaintiff had been damaged by reason of the fact that it had been deprived of a greater gain. The Court said (p. 416):

"The district court found, and this court has affirmed, that if Rochez Bros. had known of the facts which Rhoades failed to disclose to it, it would not have sold its stock in MS&R for \$598,000 in November 1967, since it would have had reason to believe, as subsequent events confirmed, that a greater gain would have been realized by retention of the stock."

In Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969), cert. den., 396 U.S. 1037 (1970), the plaintiff was induced by fraud to sell his security to the defendants, but earned a profit of 900% upon the sale (p. 573). Two years later, there was a stock split and a public offering of the securities involved. The defendants, who controlled the corporation, were aware that these events were contemplated at the time of their purchase of the plaintiff's stock. Although the value of the stock which the defendants had purchased from the plaintiff had increased substantially by the time of the public offering, it does not appear that the defendants realized the gain of which the plaintiff was deprived. The Court held that the plaintiff had delayed the bringing of his action, and on that basis had refused to award rescission. The Court awarded damages, however, based upon the price for which the plaintiff could have sold his stock on a date shortly after the public offering, had he retained the stock until

that date. The Court seemed to approve the reasoning of the District Court, which had found that (p. 573):

" . . . they [plaintiffs] would not have disposed of their stock even at that figure [a 900% profit], if they had been aware of the untruth of the avowals and the deception of the omissions, for there was then every reason to believe, as subsequent developments confirmed, that a far, far handsomer, if not fabulous, gain would be realized by retention of the stock."

See, finally, Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974), wherein the manager of an investment club used club funds for personal speculation instead of following the club's investment instructions. The Court noted (p. 113):

"Had he followed the club's instructions, the value of its portfolio at the time he left Robinson-Humphrey would have been a figure over \$48,000."

The District Court awarded damages in that amount. On appeal, the Court of Appeals said (p. 113):

"We see nothing inappropriate in the court's use of a measure of damages calculated to restore the club to the position it would have occupied had the defalcations not occurred."

Similarly, plaintiffs here seek to be restored to the position they would have occupied had they been told the truth.

The District Court in the case at bar refused to recognize any economic injury to plaintiffs based upon their

lost opportunity for gain. The Court cited a number of cases, primarily buyers' cases, in which the plaintiffs were denied recovery since they had sold their stock for no less than the amount paid for it.

We respectfully urge that this approach is not suitable to the case at bar. Here, plaintiffs were induced to leave a very substantial sum invested under the management of defendants for a considerable period of time, on the basis of financial statements and other reports which simply did not tell the truth. Defendants enjoyed the control of enormous sums of money thus left on deposit by the plaintiffs and other limited partners, and also earned substantial fees in each of the years involved arising from their management of these sums. But for the defendants' wrongful acts, they would not have enjoyed these benefits.

Nor should it be overlooked that defendants occupied a fiduciary position with respect to the plaintiffs. They were the general partners of a limited partnership and managed its investments. The duty they owed to plaintiffs was higher than that of a mere buyer toward a seller.

In Lichtyger v. Franchard Corp., 18 N.Y. 2d 528 (1966), the Court said (p. 536):

" . . . the limited partner is in 'a position analogous to that of a corporate shareholder', an investor who likewise has limited liability and no voice in the operation of an enterprise."

The Court also said (p. 536):

"There is no basis or warrant for distinguishing the fiduciary relationship of corporate director and shareholder from that of general partner and limited partner. The principle is the same -- those in control of a business must deal fairly with the interests of the other investors and this is so regardless of whether the business is in corporate or partnership form."

See also Klebanow v. New York Produce Exchange, 344 F.2d 294, 297 (2d Cir. 1965) (" . . . a limited partner is more like a shareholder . . . .").

This Court has recognized, albeit in cases unlike the present one, that damages in Rule 10b-5 cases are based in part on principles of restitution and on the idea that the injured party should be placed in the same position he would have occupied had there been no fraud. In Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir. 1972), this Court said (p. 802, n.10):

"Restitution seems to be based not only on a feeling that the party who has acted wrongfully should not be permitted to benefit from his conduct but also that the injured party should be given the benefits of a transaction he would otherwise have been in a position to enter into." (Emphasis added.)

In Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), the Court said (p. 1305):

"A second rationale supporting the Janigan rule in some situations is provided by the Restatement of Restitution §151, comment c (1937). Reasoning that the defrauded seller is entitled to be put in substantially the same position he would have occupied absent the fraud, it would allow the seller to recover the profits realized or the appreciation in value of the securities on the theory that he would have otherwise been in a position to obtain these profits for himself . . ." (Emphasis added.)

As above noted, there are situations in which defrauded sellers of securities are awarded as damages profits of which they have been deprived. Because damages in Rule 10b-5 cases are based upon general principles of restitution, because of the type of misconduct in this case, and because of the nature of the relationship between plaintiffs and defendants, we respectfully urge that this is a case in which such lost profits should be awarded. Even if it is held that such profits are not obtainable under Rule 10b-5, nevertheless we urge that they should be awarded under the Investment Advisers Act. This case involves the telling of falsehoods by an investment adviser to his client,\* to induce the client to leave money invested under the adviser's management, with the result that the client was

\* There was some dispute below whether defendants are investment advisers within the meaning of the Advisers Act, although we think there is little doubt that general partners of an investment partnership fall within the statutory definition. See, e.g., Rami Hofshi, 1973 CCH Fed.Sec.L.Rep. ¶79,441 (available July 20, 1973). The Court below did not reach this question, however, and so the status of defendants as investment advisers should be assumed, we urge, for purposes of this appeal.

deprived of a substantial profit he had earned. Section 206 of the Advisers Act was specifically designed, we urge, to prevent such conduct from occurring, and to punish it upon its occurrence.

CONCLUSION

For the foregoing reasons, the order and judgment of the District Court granting defendants' motions for summary judgment dismissing the complaint should be reversed and the case remanded for further proceedings.

Respectfully submitted,

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